

# TOWARD A THEORY OF LEADERSHIP AND STATE-BUILDING

by Roger Myerson

*Classification:* Social sciences, political sciences.

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*Abstract:* We present a theory of the state based on political leadership and reputational equilibria. A political leader first needs a reputation for reliably rewarding loyal supporters. Reputational expectations between political leaders and their supporters become the fundamental political laws on which the enforcement of all other constitutional laws may be based. Successful democratic development requires a plentiful supply of leaders who have good reputations for using public funds responsibly to serve the public at large, and not just to give jobs to their active supporters. It is argued that decentralized democracy may be the best way to improve the chances for successful democracy.

## **1. Introduction**

In state-building emergencies after the failure of a state, theoretical questions about the foundations of the state become practical concerns for planners of international stabilization missions and for their critics. This paper considers an economic theory of the state based on leadership and patronage networks, to address theoretical questions of social philosophers from Socrates to Hurwicz (1) and practical policy questions of recent state-building missions (as described in (2)-(6)).

For example, in the administration of occupied Iraq in 2003, Paul Bremer (7) refused to allow any elections in Iraq until a constitution was written, but Ayatollah Ali Al-Sistani argued that a constitution could be legitimately written only by elected leaders. In effect, they were debating a fundamental chicken-and-egg question about which should be determined first in a new constitutional republic: its founding leadership, or its constitutional rules for selecting leaders. Our leadership-patronage theory takes Sistani's side on this question; we see states founded by leaders, whose political reputations form the first constitutional laws. Bremer's

theory of the primacy of written constitutions would make it difficult to understand how they evolved in the first place. A complex system can be spontaneously self-organizing when it has many opportunities to start locally and then grow larger, which is true of leader-follower networks, but a constitutional system of government must be enforced nationally or not at all. In fact, the United States was founded by leaders who had already developed democratic reputations by serving in elected provincial assemblies under British colonial rule, and the subsequent adoption of the Constitution depended on its authors' personal reputations.

A theory of the state is derived here from economic analysis of moral-hazard agency problems; see also (8). Moral hazard is fundamental to the state. Legal and constitutional rules of government are effective only when they are enforced by the actions of individuals who have positions of responsibility in the government. By definition, *moral hazard* is the problem of creating incentives for agents to behave in some prescribed manner when their behavior cannot be directly observed by others. So the problem of getting agents of the government to enforce the rules of the state is fundamentally a moral-hazard problem, and it must be solved by an appropriate incentive system. The state's political leaders must be the ultimate guarantors of this incentive system. Thus, the state must be established by recognized leaders who can motivate an active faction or cadre of supporters.

Section 2 argues no leader can rise to power without a reputation for reliably distributing patronage benefits to loyal supporters. The extension of this reputation to guarantee the incentive system for agents of the state is considered in Section 3 as the essential role of political leadership in society. Section 4 considers how reputational expectations between political leaders and their supporters become the fundamental political laws on which the enforcement of all other constitutional laws are based. Section 5 focuses on the vital relationship between national and local leaders, which is essential for projecting state authority throughout the nation. Section 6 considers the problems of building a democratic state, in which leaders also need good reputations for providing public services that voters want. We argue that local democracy provides more opportunities for developing new democratic leadership. Section 7 concludes.

## **2. Moral hazard and leadership in competition for power**

The foundations of the state must be built anew in every generation by the leaders who win power in the state. To compete for power in any society, a leader needs the active voluntary

support of many individuals, and these supporters must be motivated by some expectation of future rewards in the event of their success. But when rivals have been defeated, a leader may be able to enjoy the fruits of power without such broad support, and so an established leader may be tempted to ignore the claims of past supporters. Thus, a successful leader must somehow credibly commit himself to reward those who supported him in the past. This is the central moral-hazard problem of political leadership.

In a simple model of sequential contests for political power, I showed (9) that, in any negotiation-proof equilibrium, a contender for power would be unable to credibly recruit any supporters without organizing a court where his supporters could depose him if he lost their trust. In this model, any would-be leader must recruit a band of captains to support him at the beginning of his career and then must challenge the current incumbent leader to a contest or battle. The probability of winning with  $n$  supporters against a rival with  $m$  supporters is computed in this model by the standard contest function  $p(n|m) = n^s/(n^s+m^s)$ , for some given parameter  $s \geq 1$ . If successful, the leader gets a revenue flow  $R$  per unit time at least until the next legitimate challenger arrives. Challenges are assumed to arrive as a Poisson process with rate  $\lambda$ , and the time rate of discount is  $\delta$ . The act of supporting a candidate has cost  $c$ . A supporter is willing to pay this cost only if he can expect a reward worth  $c/p(n|m)$  from the leader when they win. Before a contest for power, when it is expected that any rival will have  $m$  supporters, a leader with  $n$  supporters (each promised such a reward) would get expected payoff

$$w(n|m) = [p(n|m)R - nc(\delta + \lambda)] / [\delta + \lambda - \lambda p(n|m)].$$

A competitive environment in which every rival has  $m$  supporters is a negotiation-proof equilibrium if the expected payoff  $w(n|m)$  is maximized by choosing  $n$  to equal  $m$ . After winning in such an equilibrium, however, a leader with  $n$  supporters would get ex-post expected payoff  $w(n|m)/p(n|m)$ , but then he could instead get expected payoff  $R/(\delta + \lambda)$  if he repudiated his promises to all his supporters and took all the revenue  $R$  for himself until the next external challenger arrives. Thus, if his disappointed supporters could not cause him to be overthrown sooner than the leader could not credibly recruit  $n$  supporters unless

$$w(n|m)/p(n|m) \geq R/(\delta + \lambda).$$

The main result of (9) is that this inequality cannot be satisfied by any positive  $n$  when  $m$  is a negotiation-proof equilibrium.

This model shows how competition for power naturally creates an environment in which

a leader cannot recruit any active supporters unless he can credibly show that there is some mechanism by which he would risk losing power if he were to deny his promises to them after winning. That is, a successful leader must be committed to reward his supporters by a credible threat that he could lose power if he disappointed them. Although the model begins with a conquest story about origins of the state, with power won by victory in battle, the analysis nonetheless identifies an essential role for a kind of collective agreement in the establishment of a viable state. Here, however, the fundamental social contract is not between a leader and the general population, but is between a leader and the active supporters who help him to defeat his rivals for power.

But who can bind a leader who wields the sovereign power of the state? The active supporters and high officials who collectively sustain the state together have such power, if they share a sense of identity that would cause them all to lose trust in their leader if he cheated any one of them. As a minimal constitutional structure, a strong leader needs to organize a court or council where his active supporters can collectively judge his treatment of them. So in a leader's court, his reputation for reliably judging and rewarding his agents can be collectively maintained by his agents and courtiers, who monitor the leader's distribution of high offices and rewards while they serve him.

### **3. Distribution of moral-hazard rents in state offices**

This reference to high officials indicates that we must extend our view of the central moral-hazard problem to include not only moral hazard in political activity to win power but also moral hazard in administrative activity to exercise power. As observed above, moral hazard is fundamental to the state, as its laws can be enforced only by appropriate actions of the state's agents and officials. But powerful government agents often have opportunities to profit from abusing their power, and they must expect greater long-term rewards from serving the state appropriately. So in addition to basic compensation for the disutility of effort, responsible agents must expect greater rewards, called *moral-hazard rents*, as incentives for not abusing their power. Becker and Stigler (10) have shown that, in an efficient solution to dynamic moral-hazard problems, the responsible agents should be motivated by promises of large late-career rewards that will be paid if they maintain a good performance record. The prospect of large moral-hazard rents could make candidates willing to pay for appointment to such responsible offices. Becker

and Stigler suggested that such payments for office could be interpreted economically as posting a bond for good performance. (See also (11).)

The evaluation of agents' performance and their consequent rewards (or return of their performance bonds) must depend on judgments by their superiors in the administrative hierarchy, and so the system of incentives ultimately depends on top leadership. Promises of great rewards for past service become debts of the state, however. Ex post, the leaders of the state would have a direct interest in repudiating such debts. Falsely finding evidence of corruption in an official's record would relieve the state of a large expense and would open the possibility of re-selling the office to a new candidate. Thus, we find a crucial moral-hazard problem at the very top of the state apparatus. Agents of the government must trust that their top leaders will judge their performance appropriately and will reward good service generously. This central moral-hazard problem of administrative leadership in government corresponds to what Alchian and Demsetz (12) called the metering problem in firms.

Thus, we find similar central moral-hazard problems both in the political factions that compete for power and in the state's administrative apparatus. Both to win power and to wield it, political leaders need a mechanism for credibly guaranteeing the payment of promised rewards to their active political supporters and to powerful state officials. These central moral-hazard problems can be substantially combined when a new leader gives high state offices to individuals who actively supported his campaign to win power. That is, major supporters of the leader's campaign for power may be rewarded not by a direct payment but by an appointment to a high government office, which in turn entails a long-term promise of large moral-hazard rents or privileges of power. Then the leader must be credibly committed to generously rewarding the long-run service of both his political supporters and responsible agents of the state. Such a commitment is achieved when, as a political leader achieves supreme power in a state, his circle of factional supporters develops or merges into a high council of the state, where his major supporters and high officials meet regularly to monitor his decisions about distribution of offices and rewards.

This analysis suggests a basic model of political competition in which the competitors for power are leaders each of whom has organized a faction or circle of supporters. That is, we should think of the basic political actor, not as a single individual alone, but as a leader embedded in a faction of active supporters. The leader can motivate his supporters' efforts to the

extent that they trust his promises of future rewards. Communication among faction members strengthens the leader because he can credibly commit to greater long-term rewards for each of his supporters when his failure to do as promised for any one of them would cause all of them to lose confidence in his future promises. Thus, the faction forms a court that regulates the leader's relationship with each member, and so enables them all to trust the leader more.

For this system of factional accountability of leaders to be a rational equilibrium, a leader must understand that he could not recruit an entirely new faction of supporters if he lost the confidence of his existing faction. But this is quite natural; if an established political leader tried to recruit new agents to serve as his main supporters without introducing them into an existing circle of long-term supporters, then the new recruits could rationally be dubious of the leader's promises of future rewards. Grievances can be incentive-compatibly communicated among faction members because, in equilibrium, a supporter whom the leader has treated correctly should expect positive rewards from his relationship with the leader as long as he does not complain of mistreatment. When faction members are expected to meet regularly, the unexplained absence of one member could itself be taken by the others as a sign that he lost confidence in their leader. To make this equilibrium focal, the faction members must feel enough sense of identity that their leader's cheating one of them would make the others lose confidence in the leader's promises to them all.

The members of a faction have two basic obligations in this system. They must actively support their leader in winning and wielding state power, and they must actively monitor the leaders' relationship with other faction members, so that all faction members can be confident that the leader would risk losing all supporters if he failed to appropriately reward any one of them. This organization of mutual expectations among the leader and his faction makes the leader-in-faction the basic unit for mobilizing collective effort. These are the basic building blocks from which the political foundation of a state is constructed.

From this perspective, we see that the essential function of political leadership is to serve as the ultimate guarantors of incentive systems in the state. The development of bureaucratic offices and procedures can reduce the costs of moral hazard in the state, as systems of record-keeping in state offices make it harder to conceal abuses of power. But state bureaucracy requires more than just educated personnel who can manage sophisticated record systems; it also requires the basic support of political leadership. If political leaders do not support the standards for

evaluating and rewarding the service of administrators in government bureaucracies then these standards cannot be maintained against temptations of corruption.

#### **4. From leadership to constitutionalism**

We have seen that, when a political leader achieves supreme power in a state, his circle of factional supporters must naturally develop or merge into a high council of the state, where his major supporters and high officials meet regularly to monitor his decisions about distributing high offices and rewarding high officials. Such councils, where courtiers judge their leaders even as they serve them, are vital institutions in any state. Many examples can be found in the history of government, as surveyed by Finer (13). In ancient Rome, the Senate was an institutional forum where rights of senior government officials could be protected. The central institution of the medieval English monarchy from 1170 was the Court of the Exchequer, where some of the most powerful officials in England closely monitored the king's transactions with his provincial governors (who were called sheriffs). The English Parliament in its early development from 1300 could be viewed as a forum where representatives of the local gentry, who served as the government's local agents, could express their grievances against higher government officials. Such institutions can strengthen the state by guaranteeing its responsible agents that their loyal service will be appropriately rewarded, helping to solve the state's central moral-hazard problems.

These theoretical ideas have been expressed in many traditional political concepts. The faction members' two obligations may be summarized in the traditional formula of "aid and counsel" that a medieval vassal owed his lord. In this formula, aid meant supporting the lord in battle, and counsel mean regularly attending the lord's court where his relationship with other vassals would be judged. English political theory also had an old concept of sovereign power being vested in "the king in parliament," which expresses this idea that the basic political actor is, not an individual leader alone, but a leader with a group of supporters who regularly communicate about their relationships with the leader. In *Education of Cyrus* (14), an ancient classic on the foundations of successful states, Xenophon portrays Cyrus as establishing the Persian Empire on one essential quality of leadership: his reputation for generously rewarding good service.

The standards of behavior that a faction expects of its leader are a kind of fundamental

law or personal constitution for him, which he must uphold or lose the confidence of his most important supporters. These expectations must include the essential requirement of leadership, that the leader will appropriately judge and reward the services of all members of the faction. But there may be other expectations or norms which, if violated by the leader, would stimulate the same loss of trust among his faction as if the leader had cheated a prominent supporter. That is, the leader's reputation among his supporters may also be used to enforce any other constraints on the leader's behavior that are recognized by his supporters. Such norms may be defined by codes of law or religious traditions or ethnic culture. It is only necessary that a leader's violation of these norms could be observed by his supporters, and that they would consider such a violation important enough to shift their expectations to a distrustful equilibrium in which nobody has the confidence to support the leader.

In particular, the constitutional and legal system of a state may be considered well established when any major political leader would fear shocking his supporters if he blatantly violated any constitutional or legal provision. Such a linkage may be particularly natural if the leader regularly proclaimed obedience to this constitutional system while developing his relationship with supporters, so that its violation would be a shocking change from the pattern of behavior that the supporters have come to trust. Thus, the effective power of written laws and constitutions to constrain political leaders may be based on leaders' fundamental need to maintain a fragile relationship of trust with a group of supporters.

Conversely, the effective terms of a new constitutional government can be constrained by the nature of pre-existing political relationships. The rules of a new regime are not written on a blank slate. The first high officials of the regime need support to win their offices, and so they cannot be expected to abandon their past supporters at the start of the new constitutional system. Provisions of the new constitution would be unenforceable if they asked these leaders to violate the terms of longstanding relationships with supporters. In this sense, the factional norms that bind political leaders to their supporters may be seen as the essential foundation for the formal constitution of any state.

## **5. Political control of local government**

From our political-agency perspective, we should recognize the particular importance of local officials who supervise the general operation of government at the municipal and provincial

levels. These mayors and governors have the primary responsibility of ensuring that the nation has no neglected areas where a weakness of state authority could provide an opening for insurgencies to take root. Mayors and governors inevitably face great moral-hazard temptations to abuse their power over the people in their jurisdiction, however. So these powerful local offices must be associated with substantial moral-hazard rents, and the reward system for these officials must be political.

In a decentralized democracy, local officials are elected by local citizens and have autonomous constitutional powers to which national leaders must defer. The next section will argue that decentralized democracy can have important advantages for state-building, but first we should consider centralized regimes where local officials are appointed and supervised by national leaders.

A centralized regime must commit itself to appropriately judging and rewarding the service of its powerful local officials. The need to assure powerful local officials that they can expect substantial moral-hazard rents for good service means that they must have status as members of the regime's politically influential inner circle. Furthermore, support from mayors and governors can be decisive in a succession contest in an authoritarian state, and so there can be a tendency for national leaders to promise more generous standards for local officials. However, such large moral-hazard rents make local officials expensive for the regime. Thus, there is a natural incentive for narrowing the political elite and reducing the numbers and powers of politically responsible local officials, at least until the weakness of political supervision for local administration begins to create some risks of insurgency or breakdown of the state. Bates (15) depicts a tendency of autocratic states in Africa to progressively concentrate the rewards of power within a political elite that was just large enough to hold power in the capital but too small to provide good public administration throughout the nation.

This problem of political narrowness can be exacerbated when foreign forces intervene in a state-building mission to protect the new state. Political negotiations with local leaders in remote districts of the country can seem tedious and costly for national leaders who have pressing need for resources to maintain the coalition that gives them primacy in the capital. When foreign forces will defend the regime from rural insurgents, an efficient plan for the national leaders is to use rotating governorships as rewards for national-level supporters and allies while conceding as little as possible to indigenous local leaders far from the capital. Such a

plan concentrates the state's moral-hazard rents among people who have personal connections to major factions in the capital, at the cost of ignoring the political interests of people in other communities. Then foreign forces can bear the increased cost of fighting insurgency in weakly governed districts where local social leaders have little or no stake in the regime.

Conversely, if the goal of a state-building intervention were to establish a stable political regime at the least possible cost to occupying forces, local leaders could be given the strongest possible incentive to do the work of state-building by promising them a long-term share in the profits of power in their district as long as they can maintain basic control there in collaboration with the national leadership. For such promises of local leaders' long-term privileges to be credible, however, the regime must essentially adopt a feudal or aristocratic political system. For example, when the British were first establishing their colonial rule in India, they regularly granted long-term local privileges of power and taxation to local agents, called zamindars, who took responsibility for keeping order in their districts. The zamindars' local authority was granted as a permanent property right that could be sold or bequeathed to heirs, and so they became a class of local leaders with a vested interest in maintaining the regime. The effectiveness of this feudal power proved remarkably durable, but it also had long-term economic costs. Decades after India's independence, the regions where the British distributed such feudal privileges were still found to be suffering significantly lower agricultural productivity and higher infant mortality than other regions of India; see Banerjee and Iyer (16). Similar scars of colonial state-building operations may be found in many poor countries. Such a feudal solution to the problem of motivating local political supporters requires a long-term imperial commitment, however, which fortunately is not available to American forces in stabilization missions today.

Instead, we should be considering state-building strategies that support the development of democratic governments. But the principle of sharing profits of power with local leaders can also be applied in democratic regimes with federal constitutionalism.

## **6. Democratic state-building**

The focus of this paper has been on political leadership. A potential leader needs two reputational assets: he must be broadly acknowledged as a credible contender for positions of power in the state, and his promises of long-term rewards must be trusted by a faction of active supporters. The supply of such leaders is a vital part of a nation's social capital, and it can

develop only gradually over time. From this perspective, we can see that the essential problem in building a democratic state is to develop the nation's supply of democratic leaders.

A democratic leader additionally needs a reputation among the voters for respecting the rules of democratic competition and for using public funds responsibly to serve public interests, not merely to reward his active supporters. If no politicians have such good democratic reputations, then it is hard for democracy to succeed. Voters would have no incentive to turn a corrupt incumbent out of office if the alternative candidates were expected to be just as bad or worse. The key to increasing the chances for successful democratization may be to create more opportunities for more politicians to begin cultivating good democratic reputations. Such opportunities are increased by a federal system in which power is shared with independently elected provincial and municipal governments.

In (17), I developed a simple model to formalize this argument for federally decentralized democracy. In this model, success and frustration of democracy are interpreted as different equilibria of a dynamic political game in which voters have small costs of changing leadership and have incomplete information about politicians' virtue. Any untested politician has a small probability of being a virtuous type who (by nature) cannot behave corruptly, but normal politicians can choose to act virtuously or corruptly. Unitary democracy can be frustrated when voters do not replace corrupt leaders because any new leader would be expected to also govern corruptly with high probability. But federal democracy cannot be consistently frustrated at both national and local levels, because local leaders who govern responsibly could build reputations to become contenders for higher national office. If voters expected corrupt frustration of democracy at both the national and local levels, then any local leader who governed well would be recognized as virtuous and so would become a strong candidate for national leadership; but then normal local leaders would also have an incentive to act virtuously. In another version of the model, I showed that democracy cannot be consistently frustrated in a democratization process that begins with decentralized provincial democracy and only later introduces nationally elected leadership.

This argument for decentralized democracy can also be derived from the basic economic concept of barriers to entry. A successful system of democratic competition should reduce political leaders' ability to take corrupt profits from their positions as suppliers of government services. Economists understand, however, that the expected amount of profit-taking in a

competitive market equilibrium may depend on barriers to entry against new competitors. By enabling more local politicians to prove their abilities to govern responsibly, federal decentralization and local democracy can effectively reduce barriers to entry in national political competition, and so can improve the performance of national democracy. So local democracy can make national politics more competitive and thus can improve the performance of national government, by sharpening the incentive for elected national leaders to provide better public services. (See (18) for a critical survey of other arguments for federalism.)

The effect on encouraging more entry into national politics could be increased by having more elected subnational governments in smaller districts, thus creating more opportunities for more politicians to demonstrate their ability to serve the public. But there is one important constraint: The districts must be large enough, and the responsibilities of public administration in each district must be substantial enough, so that a politician's good performance in one locally elected office can be taken by the voters as evidence of his qualifications for service in higher levels of government. From this perspective, an ideal system of federal democracy should have several levels of subnational governments, with elected offices at different levels together forming a ladder of democratic political advancement that effective leaders can climb from local politics to provincial and national politics.

Devolving a share of power to independently elected local governments also broadens the distribution of rents in government, which can help to solve the narrowness problem that weakens the state against external threats and insurgencies. The narrowness problem arises when the national leader is mainly concerned about potential rivals in the capital or main population centers and thus prefers to use the moral-hazard rents of local government as rewards for supporters in the center. The result is to degrade public services and alienate local social leaders in remote districts until they become vulnerable to insurgency. The national president might be more motivated to share power with local leaders in remote districts if he could be relieved of opposition in the center by authoritarian repression. Alternatively, a federal constitution could require national leaders to devolve some power to local leaders. In this sense, a centralized democratic regime can be more vulnerable to insurgency than either an authoritarian regime or a federal democratic regime. In particular, the centralized democratic regime that was installed in Afghanistan in 2003 has been deeply vulnerable to rural insurgency.

Political parties are social networks that distribute power and privilege to their active

members. Such networks are needed to mobilize agents who have stakes in sustaining the democratic political system. Within a democratic political party, there are local agency problems which can be mitigated by local democracy. For a party to win elections, it needs local party activists who work to win the confidence of voters in communities throughout the nation. Elections to local offices can provide a measure of which local party activists have done best at gaining the confidence of the voters. In a centralized democracy that lacks such local electoral measures, party activists may understand instead that their advancement within the party is likely to depend more on their personal relationships with party leaders than on their reputations with the voters.

Successful democracy depends on vital interactions between local and national politics. We have seen that local democracy can help to make national democracy more competitive, as a record of using public resources responsibly in local government can qualify a local leader to become a competitive candidate for power at higher levels of government. Conversely, the threat of small unrepresentative cliques dominating local governments can be countered by the participation of national political parties in local democracy. Local political bosses should know that, if they lose popular support, they could face serious challengers supported by a rival national party. See (19) and (20) for evidence that the benefits of political decentralization can depend on strong competitive political parties.

## **7. Conclusions**

Government policies must be implemented by government agents, who will eschew temptations to abuse their power only if they expect greater long-term rewards from good service. So the effectiveness of the state depends on an incentive system that can promise long-term rewards for good political service. The responsibility for maintaining such a political incentive system ultimately belongs to the political leaders of the state.

Thus, we have presented a theory of the state based on political leadership. Acknowledged leadership brings powers of social coordination (see (21)), but a political leader first needs a reputation for reliably rewarding loyal supporters. Such a reputation is necessary for a leader to mobilize a network of supporters who can win political power and wield it. Constitutional laws become enforceable on the leaders of the state when a leader who violated these laws would risk losing the trust of his supporters and agents. In this sense, the reputational

expectations between political leaders and their supporters become the fundamental political laws on which the enforcement of all other constitutional laws may be based.

So the successful establishment of a new democratic state requires the development of political leaders with good democratic reputations. That is, the essential key to successful democratic development is to develop the nation's supply of leaders who have good reputations for using public funds responsibly to serve the public at large, and not just to give patronage jobs to their active supporters. From this perspective, we have argued, decentralized democracy may be the best way to improve the chances for successful democracy. Elected local governments create more opportunities for politicians to begin developing good democratic reputations. Institutions of decentralized democracy can also strengthen the state by ensuring that the state's political networks reach into communities throughout the nation.

Our leadership-based theory of state-building also suggests a different perspective on development assistance. When the goal is political development, the essential measure of success for a development project may be, not in how many schools or roads it builds, but in how the project enhances the reputations of the political leaders who spend the project's funds. The supply of leaders with good reputations for managing public funds can be increased when responsibility for spending development funds is distributed broadly among national and local leaders with transparent public accounting, as has been argued by Collier (22).

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